BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ALFRED J. AND MARGARET J. ERSTED)

For Appellants: James A. Ersted, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Alfred J. and Margaret J. Ersted against a proposed assessment of additional personal income tax in the amount of $2,180.10 for the year 1954.

Alfred J. Ersted, hereafter referred to as Appellant, was the principal stockholder of Ersted Manufacturing Co., a California corporation engaged in the manufacture of bag turning machines.

The question presented is whether Appellant suffered a bona fide, deductible loss on the exchange of a promissory note of the corporation for shares of its stock.

On November 1, 1952, the corporation borrowed $80,000 from Appellant and gave him a promissory note for that amount. By December 1, 1954, the corporation had paid $30,000 on the obligation.

As of December 1, 1954, the corporation showed on its books a deficit of $359.31, having suffered losses in every year since 1948 except for the year 1952. Included among the liabilities alleged to exist was an obligation of $130,400 which was due to Appellant on a patent purchased by the corporation in 1946. A federal revenue agent, however, had disallowed a portion of the amortization on patents for the years 1946 through 1950 on the ground that the patent acquired from Appellant should have been valued at $58,440 in 1946 rather than the $253,600 claimed.

The corporation had 100 shares of stock outstanding on December 1, 1954, with a par value of $200 a share. Appellant owned 45 shares, another person owned 33 and a third person owned 20. The third party was a donee of the 20 shares, they having been given to him by Appellant. Hereafter, the third party will be referred to as Appellant's donee.

On December 1, 1954, the dire-ctors met and elected Appellant as president, his wife as vice president, the holder of 33 shares as vice president, another person as secretary, and Appellant's son as assistant secretary.

At that meeting, the directors authorized the issuance to Appellant of a new note for $50,000 in substitution for the original note. The new note bore interest at 4 percent a year and interest and principal were payable on January 1, 1960.

On December 6, 1954, Appellant transferred the note to the previously mentioned donee in exchange for his 20 shares of the corporation's stock.

On their joint return for 1954, Appellants claimed a capital loss of $49,800, having assigned a market value of $200 to the 20 shares received in exchange for the note. Sixty percent of the claimed loss was taken into account and was used to offset a capital gain of $100,000 which was realized on December 3, 1954, on a sale of realty. The other party to the exchange, Appellant's donee, did not report the transaction on his 1954 return.,

In July 1955, seven months after the exchange, Appellant transferred 33 shares of his stock to another person, thus reducing the number of his own shares to 32. In September 1955, Appellant acquired two additional shares.

At some time in 1956, Appellant reacquired the note from his donee, paying him the sum of $2,000. On his return for that year the donee reported the sale for $2,000 of property described as "Ersted Mfg. Co." acquired in 1945 and held for more than 10 years, and took 30 percent of the gain into account.

While Appellant's donee held the note, no payments were made upon it. After Appellant reacquired it, the corporation made payments of $977.15 in 1958 and $5,377.15 in 1959, leaving a principal balance of $43,645.70.

The corporation sold most of its assets in 1958 and in 1959 Appellant cancelled the balance due on the note. At that time Appellant's son owned 50 percent or more of the corporation's stock.

Respondent disallowed the loss claimed on the exchange of the note for the shares of stock in 1954 on the ground that the transaction was not bona fide because Appellant and his donee had a prearranged agreement or tacit understanding that Appellant could reacquire the note whenever he wished.

Appellant contends that there was no such prearrangement, that the exchange was made so that Appellant could control the corporation and that the reacquisition was motivated by a desire

to place the company affairs in the best possible position in view of an illness of Appellant which curtailed his participation in the business and made liquidation, sale of the assets or sale of his stock, likely events.

During the year in question, Section 17717 of the Revenue and Taxation Code provided that "in case of a joint return by husband and wife, losses from sales or exchanges of capital assets shall be allowed only to the extent of four thousand dollars ($4,000) plus the gains from such sales or exchanges,"

If a loss is to be deductible it must be established by a bona fide transaction. (Shoenberg v. Commissioner, 77 F.2d 446, cert. denied, 296 U.S. 586 [80 L. Ed. 414]; Rand v. Helvering, 77 F. 2d 450; du Pont v. Commissioner, 118 F.2d 544; Hamlen v. United States, 31 F. Supp. 309; Hank of America, 15 T.C. 544.) The attitude of the courts is exemplified by the following quotation from Rand v. Helvering, supra, at page-451:

> If the sales by the taxpayers to Trux were complete and final with no understanding with him as to repurchase, the loss was deductible; otherwise not ... The burden was upon taxpayers to establish the above fact. Transactions of this character are necessarily secret, and the real situation is known only to the immediate parties, The Board was not compelled blindly to accept their testimony that there was no such understanding. It could examine the probabilities of such truth as revealed by the evidence of what was done.

Considering the entire record in this matter and the inferences that arise from the sequence of events, the close relationship between Appellant and his donee, the failure of the donee to report the transaction on his 1954 return, the improbability that Appellant would in fact give up a $50,000 creditor's claim for 20 percent of the corporate stock valued at $200 and the lack of a convincing motive for doing so, it is our opinion that Appellants have failed to establish that they are entitled to the loss deduction which they seek.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Alfred J. and Margaret J. Ersted against a proposed assessment of additional personal income tax in the amount of $2,180.10 for the year 1954 be and the same is hereby sustained,

Lone at Sacramento, California, this 19th day of December, 1962.

_____, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwcll L. Pierce, Secretary